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SUBJECT: JCRED REVIEWS IRAQ ENERGY ISSUES

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Summary

1. (SBU) U.S. and Iraqi delegations discussed Iraq energy issues in Amman during an energy bilateral on July 10, and during the Joint Commission on Reconstruction and Economic Development (JCRED) on July 11. The Ministry of Oil plans to expand oil production to 2.5 million barrels/day by year end, reestablish the Iraq National Oil Company, and improve the transparency of oil revenues. The Minister of Electricity stressed the need to re-build base-load capacity through the use of thermal power plants instead of additional gas turbines; highlighted several projects that are critical to increasing electricity production; and reported on efforts to reduce electricity demand growth through a public relations campaign. The Minister of Water Resources discussed efforts to increase hydropower during the peak summer season - including through agreements with Turkey and Syria to increase water flows on the Euphrates River - and highlighted the potential for additional hydropower projects.

2. (SBU) In addition to security concerns, a lack of capital investment is a major impediment to achieving these goals. The Minister of Finance acknowledged that he has been forced to cut the Ministry of Oil's capital budget to finance Iraq's projected budget deficit, and is looking for other ways to address the country's financing gap. Deputy Secretary of State Robert Zoellick urged the Iraqi delegation to address subsidies on refined products and electricity, and to identify areas appropriate for donor and private sector financing. DOE DAS John Brodman also emphasized the need for tariff reform to rationalize decision-making in the energy sector.

OIL AND NATURAL GAS

3. (SBU) Deputy Secretary Zoellick and Iraq's Finance Minister, Ali Allawi, co-chaired meetings of the U.S.-Iraq Joint Commission on Reconstruction and Economic Development (JCRED) July 11, in Amman. In addition to a plenary session focusing on the energy sector, DOE DAS John Brodman led a USG team in energy discussions on July 10, and hosted several meetings with individual ministers on the margins of the JCRED. In addition to representatives from State, DOE, and Embassy Baghdad, other participating agencies included USTDA, Ex-Im Bank and Treasury. The Iraqi side was represented by Minister of Oil Ibrahim Bahr Al-Uloum, Minister of Electricity Mohsen Shlash, and Minister of Water Resources Latif Rahid. The following summarizes discussions at the JCRED plenary, with additional details gathered from the various other meetings.

4. (SBU) Oil Minister Bahr Al-Uloum said that Iraq is currently producing 2.1 million barrels per day (MBD), a figure that is expected to rise to 2.5 MBD by year's end. The target production rate for the end of 2006 is 3.0 MBD and the Minister said that production could be restored to 3.5 MBD within several years with an additional investment of USD 4-5 billion. In the refining sector, Iraq has a current capacity of 500-550,000 barrels per day (B/D) in its large refineries and an additional capacity of 150,000 B/D in several smaller ones. Refinery utilization rate is only 70 percent, however, and the short-term goal will be to increase utilization. Over the longer term, Iraq needs to add conversion capacity to existing refineries to enable them to produce more gasoline and diesel, a project which the Minister estimates will cost USD 1 billion. Ultimately, Iraq needs to build a new refinery at an estimated cost of USD 3 billion.

5. (SBU) A significant portion of the discussions focused on natural gas and its use in generating more

electricity. Dr. Radwan Al-Saadi, Director General for Economics and Finance for the Ministry of Oil, said that Iraq was currently producing an estimated 1200 million cubic feet of gas per day (MMCFPD), but that only 40 percent of this was being utilized (i.e., 60 percent, or 720 MMCFPD, is being flared). The near term objective is the full utilization of existing production, and Al-Saadi estimated that Iraq's gas production would rise to 1600-2000 MMCFPD by 2007-2008. Over the longer term, Iraq could go beyond the production of "associated gas" - produced with its oil - to exploit some of its discovered, but undeveloped, natural gas fields. In addition to satisfying its own internal needs, the country intends to renew gas exports to Kuwait, which reached 200 MMCFPD before the Gulf War. The Ministry has also studied the feasibility of pipeline exports to Turkey, according to Al-Saadi. Eventually, it is likely Iraq will contribute some gas from its northern fields into a proposed Arab gas grid linking Egypt and Syria.

16. (SBU) Bahr Al-Uloum detailed concerns and plans regarding fuel subsidies. He noted that the consumption of fuel in Iraq has risen from 21 million liters/day (132,000 B/D) in April to 23.5 million liters/day (148,000 B/D) currently. The rise, which he attributed in part to increased use of fuel to power privately-owned generators, could drive the total cost of importing refined products to USD 3 billion this year, he noted. To address this issue, the Ministry has drafted a decree for cabinet approval to allow the private sector importation and sale of refined products. Bahr Al-Uloum said that the Ministry hopes to turn over importation of product entirely to the private sector within the next six to twelve months. The Minister also noted that a series of gradual steps to raise the price of domestically-refined product (which he referred to as the "Iran model") would be useful. The Ministry has held a series of conferences to prepare the public for these steps. The Minister acknowledged that price rises would be an unpopular move, but promised that the Ministry was moving forward.

17. (SBU) Bahr Al-Uloum stressed the importance of security to maintaining and increasing oil production. He stated that there had been 75 attacks on pipelines in Iraq over the previous five months, costing an estimated USD 1.5 billion in lost revenues. The Kirkuk Field, in northern Iraq, is capable of producing 250,000, but has been shut in due to lack of a secure pipeline outlet to Ceyhan, Turkey. Bahr Al-Uloum noted, however, that recent efforts to improve security may be bearing fruit. Over the last seven weeks, the National Energy Committee has been working with the Ministry of Defense and with MNF-I to upgrade security forces, and from June 24 to July 4, there had been no attacks on northern pipelines. "We depend heavily on this operation," he told the JCRED, pointing out that exports through Ceyhan could generate an additional USD 12 million/day, exceeding the total cost of product imports.

18. (SBU) Noting that Iraq was the only major oil producing country without its own oil company, Bahr Al-Uloum stated that a principal objective will be the re-establishment of the Iraq National Oil Company (INOC), by year's end. In response to questions from DAS Brodman, Al-Uloum clarified that the INOC would be in charge of implementation of oil field development in Iraq, while the Ministry of Oil would be restricted to strategic planning for the sector. He added that INOC would focus on production activities in existing fields, but could and should compete with international oil companies in development of new fields.

19. (SBU) The Minister told the plenary session that Iraq's petroleum law has not yet been finalized, though a number of suggested provisions had been reviewed. He said that the petroleum law would govern how Iraq dealt with foreign company investment in its oil sector, and emphasized that foreign investment would be essential to expanding the sector. Bahr Al-Uloum noted that no less than USD 25-30 billion would be needed to raise Iraq's oil production to 5 MBD, and that private sector investment would be needed to reach this goal. According to the Minister, the goal of the petroleum law will be to prepare the investment climate.

110. (SBU) Bahr Al-Uloum told the JCRED that the Ministry is reviewing the status of five to six contracts for oil fields that were signed by the previous regime. The contracts that were ratified by the Cabinet have a legal status, he noted, but in recognition of the political context under which they were signed, would be reviewed to determine their legality and competitiveness. If the contracts are found not to be competitive (Note: We assume "competitiveness" to be according to current industry standards. End Note.), they should be revised

to maximize the benefit for the Iraqi people. Bahr Al-Uloun further noted that the Ministry of Oil had expressed its opinion regarding contracts signed by Kurdish authorities: that under the TAL, management of natural resources falls under the jurisdiction of the central government, and the Ministry of Oil is the competent authority to address oil contracts.

11. (SBU) Bahr Al-Uloun reviewed for the JCRED his ministry's efforts to improve transparency of oil revenues, and Radwan Al-Saadi provided greater details during energy bilaterals. The Ministry has decided to sell primarily to major refiners, rather than oil trading companies, due to their greater reliability for lifting petroleum shipments. The Ministry is working to install metering equipment at loading ports, and is looking to hire a third-party to audit sales volumes. In the energy bilaterals, Radwan Al-Saadi detailed the Ministry's efforts to find the highest net-back prices, and solicited DOE's assistance in evaluating market options for Iraqi crude. Bahr Al-Uloun noted that, with the exception of 14,000 B/D of production that is being swapped with Syria for electricity, all oil revenues go through the Development Fund for Iraq (DFI), held by the New York Federal Reserve Bank.

ELECTRICITY

12. (SBU) Iraq's Minister of Electricity, Mohsen Shlash, noted that wars, sanctions and limited investment have degraded Iraq's generating capacity over the last 25 years, from a peak generating capacity of 12,000 megawatts (MW) in 1980. Iraq's current peak-load capacity is 5132 MW, significantly short of the country's estimated peak-load demand of 8250 MW. Moreover, this understates what should be the real demand, he said, since many of the country's factories are closed. Based on the experience of other countries, Shlash estimates that peak-load demand could rise to 15-20,000 MW by 2010.

13. (SBU) The Ministry has taken a number of steps to try to address the shortfall over the short-term. Shlash said that Iraq is extracting 500 MW more than normal (a total of 1200 MW) from existing hydropower sites, in part because Turkey had agreed to release more water into the Euphrates River. (According to Iraq's Minister of Water Resources, Latif Rashid, this measure also required the cooperation of Syria to pass along these greater volumes of water.) The Ministry of Electricity has also increased its imports of diesel fuel to 7 million liters/day (44,000 B/D) to get more electricity generated out of gas turbines during the summer peak. Other short-term measures include using 15 MMCFPD of natural gas that normally goes to a fertilizer plant in Baiji and connecting several gas turbines used for operations in the Rumaila oilfield to the national grid. The Minister hoped that these measures would provide 6000 MW next month, enough to provide electricity on a 3 hours-on/3 hours-off schedule for the entire country.

14. (SBU) Over the next year, the Ministry hopes to get more electricity from its neighbors. Iraq is interested in discussing possible interconnections with Kuwait, since the Kuwaiti high-voltage grid is only 100 kilometers from Iraq's. Shlash is not interested, however, in a proposal from a consortium of Kuwaiti businessmen because the price is extremely high. Iraq also hopes to increase imports from Iran from 95 MW to 145 MW within the next several weeks. Shlash noted that there should be enough differences in peak power demand among the region's countries to allow Iraq to acquire some surplus power generated by neighboring countries. He expressed hope that he could negotiate country-to-country agreements to get surplus power for free or at low prices, or perhaps in exchange for Iraqi promises to reciprocate in future years.

15. (SBU) Another priority for the Ministry of Electricity is the greater use of natural gas for power generation. Shlash pointed out three natural gas projects that are a priority for his Ministry:
-- Repair of the strategic gas pipeline between Southern Iraq and Baghdad;
-- Repair of gas compressor station number 2 at Kirkuk, which could provide an additional 120-130 MMCFPD of gas for power generation; and
-- Installation of a gas-oil separation unit in the East Baghdad Field to provide fuel for power generation in a strategic location in the country.

16. (SBU) Over the longer term, Shlash indicated that his priority would be to restore baseload generation capacity through the use of thermal (steam) power plants. He told his interlocutors he does not want to see any

more gas turbines. While gas turbines can be more efficient under ideal conditions, thermal plants are simpler to operate and maintain and can use practically any fuel (natural gas, residual fuel oil, or crude oil) without problems. The Ministry has identified four specific sites for power plants in the 1200-1400 MW range. He said that one project, the Al-Shimal plant, could produce 1400 MW with an investment of USD 850 million, with first production within 2 years. He is also talking to one potential donor about rehabilitation and expansion of another project, the Al-Musaib plant, which could provide an additional 1200 MW.

17. (SBU) In addition to new supplies, Shlash believes that a demand management strategy for electricity is critical. He noted that Iraqis are buying refrigerators, microwaves and air conditioners at a rapid pace, and he has appeared on Iraqi television on several occasions to urge Iraqis not to waste electricity. Ultimately, however, the solution has to include the end of heavily-subsidized electricity tariffs. Shlash indicated that the Ministry is considering a plan to provide a small amount of electricity (perhaps 400-500 kWh/month) to each household at current low prices, but to charge significantly higher prices ("almost market rates") for all power used beyond this level. The objective would be to protect poorer Iraqi households while charging higher prices for incremental volumes.

Hydropower

18. (SBU) Iraq's Minister of Water Resources, Latif Rashid, stressed the potential for additional hydropower developments in Iraq. Iraq currently has a maximum installed hydropower capacity of 2500 MW, located at eight dams, with 1200 MW now available (Note: We assume this is due to seasonal factors. End note.) He said that there are ten additional sites where large-scale hydropower projects could be constructed in Iraq. The most promising of these is the Bekma dam site, which the Minister said could add 1800 MW of generating capacity for an estimated investment of USD 1.5 billion. All together, the ten sites could add 4000-5000 MW of power, with an estimated investment of USD 6.0 billion. Rashid asserted that hydropower was one of the cheapest, cleanest alternatives for Iraq, but noted that electricity was simply "too cheap" to fund future developments. "No one pays," he lamented.

Financing the Energy Sector

19. (SBU) All three Ministers highlighted the problems associated with a lack of funds. Minister of Oil Bahr Al-Uloom said that, out of the USD 3.0 billion budgeted for capital projects for the Ministry, only USD 200 million had been disbursed so far in the year. Minister of Electricity Shlash noted that most of his budget was absorbed by the costs of importing fuel for power plants. Minister of Water Resources Rashid noted that much of the USG's budget had been absorbed by extra security expenditures, but that of the USD 4.7 billion that was to be spent by 2006, only USD 300 million had been disbursed so far. Rashid added that, of the USD 37 billion promised by other donor countries, only USD 4 billion had been disbursed.

20. (SBU) In his opening remarks at the JCRED plenary, Minister of Finance Ali Allawi confirmed that he had been forced to cut the capital budget for oil projects to cover the financing gap in Iraq's budget. He noted that Iraq's limited domestic banking sector could not finance the deficit and said that he was looking for other alternatives, including the possibility of issuing USD 5 billion in government bonds. For energy projects, Allawi said that the government needed to create an institutional framework for private sector investment. A number of investors, for example, had proposed private power stations for Iraq, and the Minister believes that there is potential to use private sector financing similar to programs done in Pakistan and Malaysia.

USG Pushes Subsidy Reform, Transparency

21. (SBU) Deputy Secretary Zoellick praised the Iraqi participants for their efforts to work together through the National Energy Committee (NEC) to meet summer electricity demands. Over the longer term, however, more must be done on the demand side. He noted that it is difficult to justify putting billions of dollars into Iraq's energy sector to support heavily subsidized prices. Zoellick acknowledged the political difficulties

inherent in subsidy reform, but stressed the need for the Iraqi side to move forward on a plan. Zoellick told the Iraqis that the energy sector should be a rich area for private sector investment and that there needs to be greater clarity regarding the roles of donors versus private sector capital. Finally, Zoellick emphasized the importance of transparency to combat the huge opportunities for corruption in the energy sector.

122. (SBU) DOE DAS John Brodman also congratulated the Iraqi Ministries on their collaboration, and reiterated USG concerns over energy subsidies. High energy prices create a "catch-22" situation for Iraq, he said, with higher oil revenues being offset by higher costs for imported fuels. The lack of real prices creates distortions and inefficient behavior throughout the energy sector, Brodman noted. He accepted that tariff reform would never be easy from a political standpoint, but urged the ITG to set the stage for eventual implementation of reforms. He stated that one key element of any strategy will be a public relations campaign to explain the need for reform to the Iraqi people.

Comment

123. (SBU) There was a lot of good news at the JCRED energy discussions. The three energy sector ministers all appear to have a good grasp of the challenges facing them, and they offered pragmatic solutions for most of them. More importantly, there now seems to be much closer coordination among the ministries to address Iraq's electricity crisis. There also seemed to be a clear understanding, across the board, of the need for greater security along the northern pipelines. Finally, all the participants appear to recognize the importance of establishing an investment climate that will attract private sector financing.

124. (SBU) On the downside, energy subsidy reform is moving at a glacial pace. Bahr Al-Uloun's proposal, to allow the private importation of refined product, has been kicking around since January, and even if implemented, would have a limited impact on the overall cost of fuel subsidies. Similarly, while the Minister of Electricity's ideas to increase rates are sound, any plan will be difficult to implement until widespread theft of power is addressed. Overall, the transitional government has a lot on its plate - including finalizing a constitution - and there appears to be little appetite for taking painful steps to reduce subsidies before the next election.

125. (SBU) The use of the Ministry of Oil's capital budget to fund Iraq's budget financing gap even as a stop-gap measure is also troubling. At the very least, it will delay the expansion of Iraq's oil production and related revenue. Given the dilapidated state of some of the country's fields, the budget cuts could even threaten current levels of production. While high oil prices have made up for lower-than-anticipated production levels this year, the failure to invest in 2005, particularly if combined with a downturn in oil prices, could spell real budgetary problems in the coming years. End Comment.

126. (U) This cable was cleared by Ross Wilson in D.

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